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INSTITUTIONAL REFORM AND THE CHALLENGES FACING SOUTH AFRICA

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Institutional Reform and the Challenges Facing South Africa

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South Africa's successful transition to a prosperous and just society will depend on more than multiracial elections and more than sensible, market-oriented economic policies, welcome as these are. Like many other countries undergoing change, South Africa will have to address instability, weak institutions of state and market, and ethnic and communal inequalities and identities. Building on experience elsewhere and on ideas from the economics of information, this paper suggests ways to create confidence in the new rules of the game, strengthen the institutions of both market and state, and manage the difficult dynamics of group inequalities.

Creating confidence. Countries undergoing fundamental changes must somehow make credible their new commitments to democracy and free markets. Otherwise, experience elsewhere indicates that investment will not emerge. The paper explores the possible use of international guarantees--perhaps even international enforcement of agreements and commitments made in South Africa by South Africans. Such devices should become more widespread in the decade ahead.

Fortifying institutions of state and market. Better institutions are needed so that democracy and free-market policies will work, especially for the poor. This entails what I call "institutional adjustment," including better information and incentives, improved property rights and the enforcement of contracts, and policies to foster competition. To illustrate principles of wider applicability, the paper discusses several examples: how to improve private-sector markets for agricultural products, for land, and for credit; and how to reform public sector incentives by linking pay to performance.

Addressing group inequalities. Without special steps, inequalities among groups will be perpetuated, and indeed may fester in new ways. Two quite different possibilities are discussed. First, labor markets must be improved through better information about capabilities and performance; freer arrangements for hiring, firing, and determining pay; and strong affirmative action programs. The latter are analyzed in new ways that emphasize their informational and symbolic properties. Second, and perhaps most speculatively, the vexing and sensitive issues of a multicultural society must be reexamined, including the investigation of how cultural characteristics may interact with different policies and local environments.

Institutional Reform and the Challenges Facing South Africa[1]

Robert Klitgaard[2]

May 1994

1. Problems After Transition

South Africa's remarkable democratic transition has filled the country and the world with joy. In a less muted fashion, perhaps, we should also be grateful for the apparent agreement of all parties on progressive, market-friendly economic policies. Like all euphorias, South Africa's cannot last, and even in the first days after President Mandela's assumption of power, there were grave reminders that difficult challenges lie ahead. (The President told listeners on inauguration day that the hard work had just begun, and tomorrow the party would be over and the labor would commence.)

In the past decade experiences in many countries show that multiparty elections and free-market reforms do not guarantee good government or economic progress. What Samuel Huntington calls the third wave of democratic reform[3] and the remarkable swing to free-market policies have often been accompanied by less welcome phenomena:

- growing corruption and crime;
- a surge of ethnic and communal tensions;
- an unpleasant sense of cultural amalgamation, of a loss of uniqueness;

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1 A revision of a longer January 1994 draft with the same title. Thanks to Chris Clague, Raphael de Kadt, Mancur Olson, Robert Picciotto, Philip Keefer, Roger Raab, and Mary Shirley for their helpful comments and criticisms. Two other papers have been hived off the January 1994 draft, including "Do Better Polities Have Higher Economic Growth?" and "Beginning at the End: An Economic Approach to Institutional Reform in Higher Education." Both are available from the IRIS Center at the University of Maryland, to which I am indebted for the funding of research assistants.

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3 Samuel P. Huntington, *The Third Wave: Democratization in the Late Twentieh Century* (Norman: University of Oklahoma Press, 199 1); Samuel P. Huntington, "Democracy's Third Wave," *in The Global Resurgence of Democracy,* ed. Larry Diamond and Marc F. Plattner (Baltimore: Johns Hopkins University Press, 1993).

- crucially, the inability of the new democratic orders and the new economic policies to deliver growth or alleviate poverty as rapidly as people expected.

Why these phenomena are apparently occurring together is a deep question worthy of much more analysis than it has received, and my own thoughts are highly tentative. (Perhaps their simultaneous emergence is coincidental; indeed, in the absence of good concepts and measures concerning some of these phenomena, it is difficult to know how one would establish scientifically just what the extent of the associations is and what might be contributing to them.) In an exploratory fashion this paper focuses on three possible underlying factors: the instability that accompanies fundamental liberalizations; the difficult environments in most developing countries, which make both market and government institutions underperform; and some surprising dynamics of group inequalities.

Instability. When economic and political systems change, there ensues a period of instability, of unclear rules of the game, which creates opportunities for scams and thefts, lies and pretensions, whose occurrence stimulates a new spiral of bad behaviour. Crime and cronyism take on new dimensions. Property rights become problematic. Moreover, instability and uncertainty deter investment. As a result, the promise of free political and economic activity is undermined.

Weak institutions of state and market. In most countries where political and economic reforms are occurring, the environments are very different from those in the established democracies and more-or-less successful market economies. For example, in many cases property rights and legal frameworks are inadequate, as in the former communist countries, or they are undermined by corruption and inefficiency, as in much of Africa and some parts of Latin America. Institutions for citizens' participation are weak, for example in the vetting of new regulations or the oversight of public agencies. In most emerging democracies information is scarce about what government agencies do, which means among other things that what state employees earn cannot be linked to what they achieve. Because of unclear, unenforced rules, a lack of transparency, and inappropriate incentives, corruption flourishes in public and private life.

Group differences and inequalities. There is also a third constellation of causes, difficult to describe because it has become difficult even to admit. After disadvantaged groups and individuals achieve a measure of equal rights and opportunities, these same groups and individuals begin to demand a "recognition" that goes beyond the universalism and individualism promised by democracy and market economics--for instance, calls for separate development, the advocacy of culturally attuned and sometimes culturally exclusive education, and the preoccupation with what some French Canadians call *la survivance*, the avoidance of cultural annihilation.[4] In a number of countries, ethnic unrest has seemed to grow even after greater democratization and economic liberalization.

After the declaration of democracy and free markets, countries encounter dilemmas of establishing and enforcing credible rules of the game, of making state and market institutions work, and of dealing with ethnic inequalities and identities. These problems face South Africa and, in different forms of course, many other countries undergoing fundamental changes. Might we speculate, using both theory and international experience, about how in the future these dilemmas can be worked out, with different degrees of success?

How might a country make credible its commitments to democracy and market-friendly rules of the game? How can institutions of both market and state be fortified in underdeveloped environments? And can we imagine policies with both symbolic and practical effects that would help advance members of heretofore disadvantaged groups?

This paper suggests some ways of thinking about these issues. Although some practical recommendations are mooted and sometimes illustrated, the abiding aim is to stimulate, not to resolve.

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[4] See Charles Taylor, *Multiculturalism and "The Politics of Recognition"* (Princeton: Princeton University Press, 1992) and Daniel Patrick Moynihan, *Pandaemonium: Ethnicity in International Politics* (New York: Oxford University Press, 1993).

Table 1
Three Factors Causing Social and Economic Problems after Democratic and Free-Market Reforms

Underlying Factor	How It Impedes Democracy and Market Economies	Lines of Possible "Solutions"
Instability	Difficult to make credible commitments to democracy and free markets, thus deterring investment; flux in rules of game encourages opportunism	Ties with international institutions; metapolitical constraints, such as constitutions; raising the cost of going back on commitments; improving the administration of justice
Weak institutions of state and market	Difficult to make democracy and free markets effective, especially for the poor	"Institutional adjustment," especially the improvement of decentralized information and incentives, competition, frontal attacks on corruption, and the participation of civil society
Ethnic and communal inequalities and identities	After the putative "victory" of the individualism and universalism of democracy and market economy, new demands emerge for political and economic equality and, at the same time, for the differentiation of group identities	??; problems seem to involve fundamental contradictions; possible "solutions" through affirmative action, a better understanding of group differences and inequalities, and the "taking into account" in policy and management of sociocultural differences and indigenous institutions

2. Instability and Fragile Commitments

A considerable amount of research shows that a country's level of investment, especially perhaps investment in equipment, is correlated with economic growth. For example, Figure 1 shows the scatterplot of average growth in real per capita gross domestic product (using purchasing power parities) and the average ratio of public and private investment to GDP, both figures averages from 1970 to 1985 for 7 1 developing countries.

INSERT FIGURE 1 ABOUT HERE

The direction of causality is not clear; it is possible that growth stimulates investment as much as or more than investment stimulates growth; and it may be that other factors influence both investment and growth, accounting for their correlation. Analyses of the factors that stimulate investment suggest that political stability and investor confidence are important. Consider this passage in a draft World Bank report on South Africa, with underlinings in the original.

> While the analysis indicates that investment (and exports) do respond to appropriate macro policies the single most important factor in stimulating investment, borne out by international experience, will be investor confidence. This will in turn come about through the implementation of sustainable, consistent, and credible policies on the economic front, as well as overall political stability.[5]

[5] Peter R. Fallon, Ataman Aksoy, Yvonne Tsikata, Pedro Belli, and Luiz A. Pereira da Silva, "South Africa: Economic Performance and Some Policy Implications," draft for discussion only (Washington: The World Bank, 18 Feb., 1993), p. 5. Incidentally, later, much longer analysis with a similar title does not contain this passage, although it does say: "A failure to revive private investment would thus put severe limits on growth. Social stability is perhaps the most critical requirement. A continuation ofexisting social tensions would totally undermine attempts to revive private sector confidence, and would make it very difficult to maintain stable economic policies" (p. 83). And: "This, in turn, will take place only if the private sector has both a clear idea of the direction of policy and confidence in the Government's policy framework" (p. 89). The World Bank Southern Africa Department, *South Africa: Economic Performance and Policies, Vol. II, Main Report,* draft for discussion only, revised (Washington, D.C.: The World Bank, 24 Nov. 1993).

The typographical emphasis is unusual in World Bank documents, but the message is not. Another recent World Bank paper contrasts Zimbabwe and Malaysia. "After independence Zimbabwe sustained a system that kept corporate profits high, but entrepreneurs faced considerable uncertainty over the environment into which they were investing; private investment remained inadeqaute for most of the 1980s." Malaysia, however, has since 1970 pursued the world's most aggressive affirmative action policies and yet grown at 7 to 8 percent annually. Why? Because it had "clear support for the private sector, a high degree of openness and prudent macroeconomic management; this supported private sector confidence and sustained private investment growth."[6]

In many countries that have undertaken free-market reforms, investment does not automatically surge in the first years thereafter, even in the first decade. In Bolivia, for example, almost no increase in private investment took place in the first five years after the country's bold 1985 stabilization and liberalization of the economy. Senegal was one of the first countries to undertake "structural adjustment," the World Bank's term for free market reforms and macroeconomic austerity. In 1980 Senegal received its first structural adjustment loan from the World Bank. But from 1980 to 1992, industrial sector employment did not grow, and investment was stagnant. Even after four structural adjustment loans, it appeared that many of the country's free-market reforms still hadn't taken.

To explain such weak economic responses, many Bolivians and Senegalese and international observers blame "investor confidence." Words like credibility, consistency, and sustainability--some of those underlined words in the World Bank report on South Africa--are trotted out. And this raises a natural question: what is it that a country has to do to "sustainable. consistent, and credible policies" and engender "overall political stability"?

Beyond the merits of this constitution or that package of economic reforms, are credibility and stability the key issues? Harvard economist Richard Zeckhauser has studied "fragile commitments." He examines a variety of problems where we would benefit from a credible, consistent, sustainable commitment to a policy or a principle, but

[6] Brian Kahn, Abdel Senhadji, and Michael Walton, "South Africa: Macroeconomic Issues for the Transition," Informal Discussion Papers on Aspects of the Economy of South Africa, Paper No. 2 (Washington, D.C.: The World Bank, May 1992), p. iii.

where we lack mechanisms to make the commitment credible to others.[7] Is this also the central problem facing developing countries in unstable environments--and in particular societies undergoing major and uncertain transformations such as South Africa? If so, how might fragile commitments be fortified?

Beyond Words

Words will not be enough. Words are cheap, even when they express passion and principle. "A lot depends," pronounces one of the World Bank papers on South Africa, "on how mutually reinforcing both the economic and political strategies could be and on how fast they will be able to produce a stable and credible economic and political environment."[8] A similar point has been made by political scientist Barry Weingast in a survey of "The Economic Role of Political Institutions." His historical and comparative analysis "suggests that redesigning economic and political institutions should be attempted simultaneously. In particular, these institutions need to be consistent with one another."[9] In his summary Weingast uses italics instead of underlining: "Providing for the security of a private market economy requires a set of political institutions that credibly *commit* the state to those markets--i.e., that limit future political discretion with respect to economic decisions."[10] If a country decides it wants to have "mutually reinforcing" economic and political orders, how can it credibly commit to them?

The problem of commitment goes beyond macropolitics and macroeconomics. For a variety of reasons, many developing countries, and sometimes countries considered quite developed, are characterized by imperfect systems of enforcement. Societies with weak enforcement mechanisms for contracts and loan repayments, for rights and laws, suffer in many ways. Economic agents will forgo some useful transactions, for fear that if one side fails to live up to the bargain redress cannot reliably be sought. It has been said that a

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[7] See, for example, Dani Rodrik and Richard Zeckhauser, "The Dilemma of Government Responsiveness," *Journal of Policy Analysis and Management*, Vol. 7, No. 4 (1988), and Glenn Blackmon and Richard Zeckhauser, "Fragile Commitments and the Regulatory Process," *Yale Journal on Regulation*, Vol. 9, No. 1 (Winter 1992) See also Avinash Dixit and Barry Nalebuff, *Thinking Strategically (New* York: W.W. Norton, 1992), ch. 8.

[8] Fallon *et al.*, p. 7.

[9] Barry R. Weingast, "The Economic Role of Political Institutions," Working Paper Series IPR46 (Washington, D.C.: Institute for Policy Reform, September 1992), p. 45.

[10] Weingast, p. 1.

fundamental economic right is *the right to be sued*--for this right, guaranteed by a third party, is essential to being able to enter into a contract.

For example, imperfections in systems that enforce the repayment of loans are a source of the failure of formal credit markets, which in turn constrains the initiation and expansion of small business and the adoption of modem agricultural techniques. When enforcement is weak, governments undertake compensating policies that in turn create their own inefficiencies. Sometimes, for example, governments simply take over activities that are not served efficiently or justly by a private sector that is unable to fulfill its potential because of shortcomings in contracting, enforcement, property rights, and related problems. Under such conditions "competition" may not be free and fair, and sometimes governments will respond by creating reams of red tape in an effort to control unruly markets, which in turn create new obstacles to free enterprise.

Even when governments do not interfere, if enforcement is weak, the private sector itself tries to find other ways to do the enforcing, thereby creating new inefficiencies. For example, in the absence of credible contracts, people will transact within families or clans or mafias, where enforcement is possible if socially inefficient. And often, I fear, the reaction of much of the private sector to an absence of enforceable agreements is simply to consume now rather than to invest. Many citizens in developing countries favor immediate consumption because the fruits of longer term investment are precarious.

In short, it is an important part of the enabling environment for free economic activity that agreements once reached can be credibly enforced by third parties. Third parties can fortify fragile commitments, indeed can enable commitments that otherwise would fail to exist. (Notice that the third party does not specify the details of the commitment but simply serves to guarantee through promises of enforcement the commitments that independent agents wish to undertake.) Might third parties also help an emerging democracy and an emerging free-market economy make its policies and commitments credible?

Mergers?

One solution, unavailable to most countries in transition, is to merge with a stable neighbor. As Gerlinde Sinn and Hans-Werther Sinn emphasize, the East Germans simply adopted the West German system thereby overcoming the problem of fragile commitments.

"In most of the Eastern European countries," they write, "the main problem of the transformation process is to find an efficient institutional framework for economic activity and to set it up quickly. These countries will have to spend the next decade carrying out this task, and the market economy will only be able to develop properly there after this task is completed.

"East Germany is in the happy position of being able to take on West Germany's institutional framework. The legal system, the organizations, and the trading practices and customs that the new states need are all, in principle, defined and available for use."[11]

Obviously this alternative is available to few countries. Even when it is a possibility, as in the merger of the two Yemens several years ago, recent events make one question the results. Indeed, the costs of the German merger may run as high as a trillion dollars over the first decade, and the decline of East German industrial production since unification has in percentage terms been the greatest, the Sinns report, in world history.

New Roles for international Actors?

If a merger is not feasible or desirable, are there other ways to make credible commitment with the help of international partners?

Somctimcs within countries undergoing rapid change or civil disorder, important agreements and transactions may not be reached because the negotiating parties cannot count on enforcement--that is, they cannot make their commitments credible. A useful function for an international "third party" is to guarantee agreements once reached, without becoming involved in the negotiations or attempting to influence the solutions. The World Bank or the United Nations or someone else would say, "If you want us to do so, we will be happy to enforce in an agreed-upon way any commitments you wish voluntarily to undertake." This in turn would facilitate negotiations.

Outside agencies and government have been criticized for becoming too deeply involved ***in*** the ***what*** of policy making in developing countries. But notice that part of the role of international institutions might usefully be recast ***as*** the ***enforcer of agreements once reached.*** In economic policy making, for example, if a country for its own sake wishes to impress foreign donors and lenders, and investors both domestic and foreign with the "soundness" of its economic plans, one way to do so is to invite international

[11] Gerlinde Sinn and Hans-Werner Sinn, *Jumpstart: The Economic Unification of Germany*, trans. Juli Irving-Lessmann (Cambridge: MIT Press, 1992), pp. 180-l

organizations (1) to participate in the design of such plans and (2) (the point I am emphasizing here) to enforce the government's own commitment to those plans, in order that the commitment thus made less fragile would be more likely to inspire confidence.

What might "enforcement" mean? Sometimes merely having a third party monitor the agreement and inform everyone that it is or is not being met is enough. Sometimes it will be sufficient to guarantee each party to an agreement that if the agreement is violated, the international community will provide compensation.

Sometimes there may need to be the threat of penalties to anyone who violates his commitments. Here one might imagine a number of possibilities, some specific to the transgressing party and others penalties against the country as a whole--jawboning and international criticism the withdrawal of foreign aid, or even the enactment of various mild to strong sanctions.

The qualitative point is this. If an international institution redefined (part of) its comparative advantage as the enforcement of agreements made by others, it could open up new possibilities for successful negotiations. This is "interventionist" only in the mild sense that it creates an enabling environment for agreement. Just as the ability to be sued enables contracts, so might the ability to be penalized internationally enable negotiated settlements. This particular brand of participation by the inter national community would render commitments less fragile.[12]

Following this logic, a country such as South Africa may find it useful to take several steps that "on their merits" might be undesirable. For example, it might enter into an agreement with the International Monetary Fund that included strong conditionality and, contrary to the usual norm, might publicize widely its key provisions. Among these might be a condition mentioned in campaigning by the African National Congress, that the government budget deficit will not exceed 6 percent.

For another example, South Africa may wish to fulfill the conditions of entering the General Agreement on Tariffs and Trade more rapidly than is currently planned--and more rapidly than might on the economic face of it seem desirable. Moving dramatically to liberalize South Africa's trade regime might credible signal that the new government is

[12] Julio A. Santaella discusses how in the 1920s Austria, Hungary, Greece, Bulgaria, Estonia, and Danzig were able to make their policies more credible with the help of external enforcement from the League of Nations. "Stabilization Programs and External Enforcement: Experience from the 1920s," *IMF Staff Papers*, Vol. 40, No. 3 (Sept. 1993).

sincere about its commitment to free markets, leading to a boost in confidence that might outweigh the economic dislocations caused by abruptness.

I believe that an important challenge for the last half of the 1990s is inventing new ways that sovereign nations can in effect buy into international guarantees of their democratic orders and economic policies, For example, the new European Bank for Reconstruction and Development only gives loans to democratic governments pursuing free-market policies. This restriction helps recipients make credible commitments to reform. An interesting question is whether the United Nations or various Western democracies might develop similar conditions for aid, which would have the important benefit of rendering more believable a country's policies. Or whether countries like South Africa can itself devise new international arrangements.

Internal Mechanisms for Commitment

In the meantime, South Africa seems currently to exhibit several instructive examples of a new government trying to commit itself

A government of national unity. The major parties participating in South Africa's democratic transition agreed to an arrangement for partitioning not only seats in the legislature but also cabinet positions among parties. Indeed, a party gaining 20 percent or more of the vote would receive a Deputy Presidency.

Since taking power President Mandela has reinforced these structural signals. He has allocated crucial cabinet posts to parties besides his own: For example, the Ministries of Finance, Mining, and Agriculture have gone to the National Party, and the Home Affairs portfolio has gone to the Inkatha Freedom Party. In his first days in office President Mandela has also made national unity the keynote of his new adminstration. Presumably all these efforts send a signal that because the new structures of government will be broadly based, the commitment to both democracy and responsible ***economics will*** be difficult to undo.

Processes. The ANC's Reconstruction and Development Plan went through seven drafts. At each stage there were public and private meetings to disseminate its ideas and receive comments and criticisms. Nelson Mandela cited this process in his debate with F.W. de Klerk. The way the plan was vetted--perhaps more than the fact that a plan was produced--makes it more difficult for the new government to alter it fundamentally. More than thus usual party platform, then, or even the usual national development plan, the RDP carries the weight of commitment.

The Constitution. The draft constitution was the result of another arduous process, which again legitimizes it and makes changing it difficult. The constitution allows itself to be changed if two-thirds of the national assembly votes to do so. For a time in the lengthy process of counting votes, it appeared that the ANC might garner 67 percent. President Mandela reassured the public that even if the ANC did receive such a mandate, it would not use its powers to change the constitution. A few days later, when the final vote turned out to be less than 67 percent, President Mandela expressed his satisfaction that his party had not received it: another manifestation, perhaps, of the President's sensititivity to the need to commit his government not to change the rules of the game.

3. Improving Market Institutions

Garden-variety economic theory teaches that there are many reasons why markets may fail to achieve efficiency, and why therefore collective action of various kinds, including by governments, may make everyone better off. Recent work in the economics of information and in game theory emphasizes further forms of market malfunctioning, or even nonexistence. An irony of late-twentieth-century economics is that just as the superiority of free markets is acknowledged as never before by politicians and lay people around the globe, economists are discovering new reasons why market outcomes will disappoint. [13]

For example, when the quality of a good or service or fact& of production matters and it varies, when information about quality is expensive and asymmetric, and when parries have an incentive to mislead, then competitive markets will not in general lead to Pareto optimal allocations of resources.[14] These conditions are widespread in developing countries, and they help explain why markets affecting the poor for labour, credit, and agricultural inputs and outputs often do not live up to their promise.

The argument assumes nothing about exploitative structures or dependency relations. Following the usual logic of economic theory, we suppose for a moment that individuals are calculating profits without regard to centers or peripheries, classes or clans,

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[13] As one of the pioneers of this way of looking at the world puts it, "The competitive paradigm is an artfully constructed structure: when one of its central pieces (the assumption of perfect information) is removed, the structure collapses." Joseph E. Stiglitz, "Information and Economic Analysis: A Perspective," *Economic Journal, Supplement,* Vol. 95 (1985), p. 26.

[14] Robert Klitgaard, *Adjusting to Reality: Beyond "State vs. Market" in Economic Development* (San Francisco: ICS Press and International Center for Economic Growth, 1991), chs. 3-5.

Paris or Pretoria. They look at market risks and find that they can judge some of those risks more easily than they can judge others. They investigate possible contracts for products or loans or services to be rendered, and ascertain that some of those contracts are more easily specified and enforced than others. When they compare equally profitable investments, they take the line of least risk and tightest contract. And this line systematically favours the rich and the urban--without anyone's explicitly wishing for that outcome. Structures of information and contracting crucially determine the efficiency and fairness of even highly competitive markets.

As a result the *institutions* of the market--concretely, the banks and personnel offices and purchasing agents and firms; and more abstractly, the markets for credit and labour and many other products--do not reach the poor effectively. Markets "fail," or even fail to exist; and other institutions take their place, as the poor strive to shield themselves from risk, guarantee compliance, create property rights, obtain credit, and find people to buy their labor and their products. These institutions include share-cropping, interlinked transactions, clan ties, gifts, age groups, and social customs. They often have economic as well as other functions and meanings. Markets affecting the poor are often overlain with competition-restricting practices that persist in part because they provide information, reduce risk, facilitate quality control, or enable contracts.

Take agricultural markets. Like other markets, they flourish when prices are free and widely known, competition for inputs and outputs is robust, contracts are honored, quality grades and standards are rational and clear, alternative technologies are widely understood, and transactions costs are low. But in many rural areas of developing countries, these conditions are lacking, especially for the poor.[15] As a result, around the developing world we find disappointing results with the usual approaches to agricultural reform, such as "liberalized" agricultural markets, land reform, and breakthroughs in technology. [16]

The solutions go beyond the usual alternatives, such as "getting prices right," "getting the state out of agriculture," or even "redistributing productive assets." In healthy economies, the state and the private sector work together to generate, disseminate, and certify market information; promote competition; enforce contracts; design and enforce

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[15] For examples, *see The Economics of Rural Organization, ed.* K. Hoff, A. Braverman, and J.E. Stiglitz (New York: Oxford University Press for the World Bank, 1992); *The Economic Theory of Agrarian Institutions,* ed Pranab Bardhan (Oxford: Clarendon Press, 1989).
[16] Klitgaard, *Adjusting to Reality, chs. 3* and 13.

grades and standards; develop and disseminate appropriate technologies; and invest in infrastructure that lowers transactions costs.

Consider another example, credit markets for the poor. It is difficult for banks to distinguish good risks from bad in any case, but all the harder when the loan applicant is poor, lacks collateral, is from a different social background, and has no experience with formal sector credit. A 1991 HSRC report asked South African bankers to grade different factors they used in deciding whether or not to grant a loan. The most important was the applicant's credit references; next was owning fixed property that could serve as collateral.[17] The poor seldom have either, at feast not in forms readily interpretable or usable by formal sector banks. No wonder, perhaps, that in one survey in South Africa only 6 percent of very small businesses have received any formal sector credit, and no wonder that it has been estimated that only 2 percent of credit from banks in South Africa goes to blacks.

When information about risk is imperfect, and when people who are good risks have few means-to guarantee that they are, markets will react by favouring the already favoured, those with assets, those whose information is easily digested. Deregulation and competition alone will not overcome these problems. Nor will risk-sharing programs such as the guarantee funds now provided in South Africa by the SBDC and the DBSA, welcome as these are. We need policies that help make market institutions work better.

To be somewhat more concrete, let us briefly examine several examples in South African agriculture, In 1991 agriculture accounted for just above 4 percent of South Africa's GDP, and in 1985 commercial agriculture employed about 1.1 million people. As a percentage of GDP, then, agriculture in South Africa seems of minor importance, certainly when compared with most other developing countries. But agriculture plays a more central role than it might appear. The country is self-sufficient in food. Agriculture is said to provide "essential raw materials" to around one-quarter of the country's industrial enterprises, and about 40 percent of black South Africans reside in rural areas.

In 1985, so-called commercial agriculture, almost entirely owned by whites, occupied about 88 million hectares, 14 percent of which was cultivated. In contrast, subsistence agriculture, which is almost entirely black-managed, occupied about 15 million

[17] R. Hirschwitz, I. Acutt, and A. Koch, *Training for the Informal Sector* (Johannesburg: HSRC Publishers, 1991), cited in Grant Brann, "Credit for the Informal Sector and the Role of Formal Sector Banks," unpublished ms., October 1992.

ha., of which again 14 percent was cultivated. (The surface area of South Africa is about 122 million ha.)

South African agriculture is sometimes called modern and highly efficient. The picture is much different in black rural areas. There, agriculture tends to be inefficient, and most of these areas are food importers. For example, in 1982 maize yields on black farms averaged 304 kg. per ha. in 1984, compared with 3500 kg/ha. on white farms. The Tomlinson report estimated that if economic conditions were the same in black rural areas as in white areas, black farming regions could produce 23 percent of total farm output, but in 198 1 the actual figure was less than 6 percent of that total.

Low prices for black farmers do not appear to be the culprit. In KwaZulu, for example, farm-gate prices are typically much *higher* than market prices in white areas--indeed, as we shall shortly see, sometimes higher than retail prices in urban areas. Despite the higher prices, most black families in KwaZulu receive almost no income from crops.

Experience in other countries and lessons from the economics of information suggest that malfunctioning market institutions may be partly responsible for these inequalities. Space permits a brief mention of three: product markets, land markets, and credit markets.

Agricultural Marketing

By international standards agricultural marketing in South Africa has been highly controlled. The past decade, however, has seen a greater use of market forces in the marketing of both inputs and outputs. Regulations about hygiene, the movement of commodities, and production and packing standards remain rigorous by international standards. But many subsidies have been removed, and for many products domestic and world market prices have converged. The marketing of dairy, eggs, and poultry has been deregulated, although that of maize and wheat remain highly controlled. Quantitative restrictions on imports have increasingly been replaced with tariffs, reducing the levels of effective protection and improving transparency.

Nonetheless, considerable monopoly power remains in the private sector. Agribusiness in South Africa is strongly linked, characterized by high concentration ratios, extensive vertical and horizontal integration, and interlocking directorships.

And so it is that many people are interested in deregulating South African agricultural marketing--for example, removing state monopolies and competition-stifling requirements. Our research approach suggests that government may also need simultaneously to take other actions that strengthen the institutions of competitive markets. As a recent World Bank document observes:

> In the opinion of many analysts they [regulations on agricultural markets] are too rigorous, in that they form barriers to entry of new and informal enterprises, and in some cases militate against the interests of low-income consumers. . . There is a strong case for measures to promote the informal sectors of the economy, which are already growing, with a review of the regulatory framework as part of this process. Marketing arrangements within the former homeland areas and TBVC need to be carefully assessed in terms of whether they have valid roles in the future. [18]

Like many other markets, agricultural markets flourish best when prices are free and widely known, competition for inputs and outputs is robust, contracts are honored, grades and standards are rational and clear, alternative technologies are widely understood, and transactions costs are cheap. And in many rural areas of developing countries, these conditions are lacking, with the result that "liberalized" agricultural markets, land reform, and breakthroughs in technology may fail to deliver.

The answers go beyond "getting prices right," "redistributing productive assets," and "getting the state out of agriculture." It is a good first approximation to think of ways to get government off the back of producers and consumers and to let markets determine prices. But only a first approximation. In healthy economies, the state helps to generate, disseminate, and certify market information; promote competition; enforce contracts; design and enforce grades and standards; subsidize and disseminate appropriate technologies; and invest in infrastructure that lowers transactions costs.[19]

Some of these themes have been explored by my student Faith N. Shange in her research for this project. Shange examined maize markets in KwaZulu, in particular the possibility that low production stemmed in part from marketing problems.

Her first finding was that farm-gate prices in KwaZulu rural areas are typically much *higher* than market prices **in white** areas--indeed, sometimes **higher than retail prices** in urban areas. Table 2 gives some examples:

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[18] The World Bank, "Briefing Note: Agriculture and the Rural Economy in South Africa," p. 4.
[19] *See,* for example, Klitgaard, *Adjusting to Reality, chs. 3-5,* **and** *Economics of Rural Organization,* ed. Karla Hoff, Avishay Braverman, and Joseph Stiglitz (New York: Oxford University Press, 1993), ch. 1.

Table 2

Some Agricultural Price Differences[20]

Year	Product	KwaZulu	Commercial Sector
1985	Cabbage	R0.40/each	R0.225/each
1985	Maize	R3 1 5/ton	R220/ton
1988	Grain	R399/ton	R240/ton

Despite the higher prices in black areas, many families gain no income from crops. A survey conducted in three tribal wards in 1990 (Amaci, Hlabisa, and Khanyile) found that 64 percent of households derived zero income from agricultural activities and instead "relied on remittances and welfare income for their survival."[21] In 1987 Norman Bromberger surveyed the residents of Vulindela. Using his data, Shange calculated the income derived from farm activities and compared it with money wages. The former was about 4 percent of the latter.[22]

Shange's research shows that rural markets in KwaZulu are thin to nonexistent. KwaZulu's population is spread out over often mountainous terrain with poor roads. Many young men have migrated to the cities. Credit, inputs, and agricultural extension are thinly supplied. With small-sized farms and relatively primitive agricultural technologies, yields are much lower per hectare than on white farms in neighboring Natal and elsewhere. For a number of reasons whose relative importance is difficult (but important) to gauge, it appears that increasing maize production in KwaZulu is not commercially viable.

Across several rural areas of KwaZulu, David Lyster recently found that about five-sixths of the farmers said they would be happy to sell agricultural produce if they only had any surpluses to sell.[23] He implied that the supply side is the problem. But what about

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[20] David M. Lyster, *Agricultural Marketing in KwaZulu: A Farm-Household Perspective* (Pietermaritzburg: Department of Agricultural Economics, University of Natal, *1990);* and *Maize Production in KwaZulu: A Handbook for Extension Officers and Farmers* (Pietermaritzburg: Institute of Natural Resources, University of Natal, 199 1).

[21] Shange, *Agricultural Product Markets,* . , p. 2 1.

[22] Shange, *Agricultural Product Markets.* . , Appendix 1.

[23] David M. Lyster, *Agricultural Marketing in KwaZulu: A Farm-Household Perspective* (Pietermaritzburg: Department of Agricultural Economics, University of Natal, 1990)

outlets for supply? Elizabeth Ardington wrote in 1984, “There is certainly little need for markets [i.e., physical market places in rural arcas] at thc moment but production will not increase unless stable markets are established. There is no point in producing a surplus which cannot be disposed of."[24]

Simultaneity problems lurk, indeed barely lurk. Might well-functioning market institutions **for** maize and other agricultural products *enable* demand to stimulate supply? Or are black farmers simply unable to compete in maize? In KwaZulu, are markets missing because of problems of imperfect and asymmetric information?

Work in other countries support explanations along the lines of George Akerlof's “market for lemons,” where the absence of credible information about the quality of agricultural products lcads to market failure.[25] We cannot yet judge how important problems of “quality and markets” are in KwaZulu agriculture. Shange wonders whether the establishment of periodic markets in KwaZulu might prove catalytic. Difficult as it is to believe, there are almost no market places around KwaZulu. “Before marketplaces can be built, some research would have to be conducted to identify probable growth points and determine consume demand and market potential at the local level. A series of weekly or biweekly markets, operating for a half or whole day and taking place in a ring around a central place” would “encourage small producers to participate in the sale of surpluses,” a practice that is rare in KwaZulu today.[26] In her interviews with farmers, merchants, and KwaZulu officials, she discovered support for “pre-marketing education,” which would explain the functioning of market systems, including grades and standards and price-quality relations. Agricultural **extension officers would be included in these efforts.** Finally, Shange recommends the greater use of the radio to disseminate market information, particularly about prices by grade. Radio Zulu now produces a farmers' program called "Cobela Ku Falaza Mlimi," which disseminated information about pesticides, insecticides, planting, and so forth. She asks that the same show experiment with information about markets.

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[24] Elizabeth Ardington, Carnegie Conference Paper No. 53b, in *Second Carnegie Inquiry into Poverty and Development in Southen Africa*, Vol. 5 (1984), cited in Shange, p. 23.
[25] George Akerlof, “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics*, Vol. 84, No. 3 (August 1970); see also Khtgaard, *Adjusting to Reality,* chs. 3-5
[26] Shange, *Agricultural Product Markets . . .*, p. 34.

Markets for Land

Land use in black agriculture in South Africa "poses a paradox," in the words of a recent World Bank document. The average amount of arable land per household ranges from 0.2 ha. in Qwaqwa to 1.5 ha. in the Transkei. compared with 3.8 ha. in white-controlled areas. "High population densities, small land holdings and limited access to technology, extension and inputs, all contribute to low levels of land productivity. . . as much as 30% to 50% of arable land in certain homelands is uncultivated."[27] In KwaZulu only 10 percent of total land is cultivated, and about 67 percent is used as natural pasture. Of KwaZulu's arable land, almost two-thirds has been classified as having "high cropping potential," yet more than 20 percent of it is left fallow.[28]

Why should this be so? In many "black" areas of South Africa, land markets are highly constrained by traditional or "tribal" property rights. In contrast, land markets in commercial "white" agriculture seem remarkably active. For example, in 1990 about 8,500 parcels were transferred nationwide, representing 3.5 million acres. Over the past decade, foreclosures and insolvencies rarely exceeded several hundred farms per year, a relatively small proportion of land market transactions.

The arguments for property rights are several. Secure and stable rights induce investment. Property rights enable land to be used as collateral, which in turn diminishes credit constraints. Finally, property rights may enable gains from trade, since with them individuals can dispose of assets in ways not previously possible.[29] Around the world, experiments with land titling are attracting widespread interest.[30]

In Africa, the effects of titling lands that were once under traditional or tribal jurisdiction has been mixed.[31] Obvious political constraints make it difficult to grant individual titles in places like KwaZulu. But several South African researchers are

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27 The World Bank, "Briefing Note: Agriculture and the Rural Economy in South Africa," p. 3.
28 Michael Lyne, quoted *in* Shange, *Agricultural Product Markets in KwaZulu*, p. 21.
29 Timothy Besley, "Property Rights and Investment Incentives: Theory and Micro-Evidence from Ghana," Discussion Paper # 170, Woodrow Wilson School of Public and International Affairs, Princeton University, April 1993.
30 For example, Hernando de Soto's celebrated Peruvian NGO has developed rapid laser- and computer-based techniques for adjudicating land boundaries and entering land titles. The anecdotal evidence reports a reduction in adjudication and haggling and an increase in investment, and *other* countries in Latin America are coming to Peru to learn how to replicate the process.
31 David Atwood, "Land Registration in Africa: The Impact on Agricultural Production," World *Development,* Vol. 18, No. 5 (May 1990).

investigating the creation of rental markets for land in "tribal" areas.[32] Our approach suggests that such an idea be coupled with the enhancement of information flows about the quality of land and the quality of rental contracts (meaning the likelihood of reneging or of local political supravention of rental agreements). Government action may be a useful catalyst to a more efficient rental market.

The experience of Zimbabwe and other countries suggests that the mere transfer of land to blacks is no guarantee of success. "Consequently, the problem of designing and implementing sustainable agricultural services is one that [the Zimbabwe] Government is currently addressing . . [South Africa will need to devise a] sustainable plan for restructuring existing agricultural institutions--chiefly research, extension, credit and marketing--in order to meet the needs of small-scale farmers."[33]

Agricultural Credit

Because markets for risk are incomplete in rural areas, a variety of institutions has emerged that serves fanners' interlinked needs for credit, risk-sharing, and reliable supplies and demands. Farmers often complain of a lack of formal-sector credit. Banks respond by pointing to high overhead costs per r-and loaned and high default rates on loans once made.

These problems are certainly not confined to South Africa. But they become more sensitive when bias against credit to the poor correlates highly with race. Two alternatives tend to dominate discussions of what to do. The first approach suggests the elimination of racially based credit practices such as "red-lining" and the abolition of interest-rate ceilings (and subsidies). The second approach, favours compensatory action. It asks the state to consider subsidizing interest rates for certain groups, or (less directly) to subsidize the establishment of financial institutions for certain groups or regions.

The approach suggested here calls for detailed investigations of market and non-market f&lures due to information, incentives, and enforcement. The vast literature on rural credit programs leads to certain possible policy suggestions:

1. Improve information about loan procedures and about the riskiness of individual loan applicants. For example, improve data on crops and yields, land values, and credit

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32 Michael C. Lyne and W.L. Nieuwoudt, "Inefficient Land Use in KwaZulu: Causes and Remedies," *Development South Africa,* Vol. 8 (1991), pp. 193-201.
33 The World Bank, "Briefing Note: Agriculture and the Rural Economy in South Africa," p. 5.

histories. All of these steps lower the costs to banks and farmers ofjudging the value of a loan.

2. Stimulate the use of co-guarantees and other forms of group credit. Larger loans are thereby enabled, which reduces transactions costs per rand of credit. Moreover, the creation of such groups creates economic incentives to carry out credit screening and the enforcement of repayment. In both domains local people are likely to have information and means at their disposal that a bank does not.

3. Stimulate the formation and use of intermediate organizations such as community groups specifically for the purpose of screening loan recipients and enforcing repayment. Such a mechanism seems to have been in operation in the launching of South Africa's successful black taxi industry.

4. Clarify property rights, which among other things enable loan markets to work more efficiently

5. Encourage better incentives for staff members of financial institutions. In the fascinating case of Indonesia's highly successful rural credit program, a key ingredient was paying bank staff members in part on the basis of the amounts of loans made and the repayments received.[34]

To return to the broader message concerning South Africa's agricultural inequalities: Economic theory and experience in other countries have much to teach us about the ways agricultural markets can malfunction, to the detriment of society's most disadvantaged members--and about the ways that government action may help markets work better. Economic policies toward markets must go beyond stability in the sense of low inflation and stable rules of the game, and beyond liberalization and deregulation, in the sense of freeing prices and reducing government interventions. Let this not be misunderstood: stabilization, liberalization, and deregulation are usually welcome steps, sometimes necessary ones. But because of real-world problems of imperfect information and contracts, even markets that are stable and free can be predicted to serve the poor less well than the privileged. Systematically.

But not inevitably--if we take these problems seriously, analyze them carefully using modern economics and detailed market studies, and adopt appropriate policies.

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[34] Richard H. Patten and Jay K. Rosengard, *Progress with Profits: The Development of Rural Banking in Indonesia* (San Francisco: ICS Press and International Center for Economic Growth, 1991).

Guidelines for improving Market institutions

The problems we have been discussing are not confined to agricultural markets. In markets ranging from labor to housing, and in particular with regard to the urban informal sector, market institutions often underperform for reasons perfectly understandable in economic theory. For example,

- when the quality of a good or service or factor of production matters and it varies,
- when information about quality is expensive and asymmetric, and
- when parties have an incentive to mislead,

then competitive markets will not in general lead to Pareto optimal allocations of resources. Table 3 summarizes a framework for analyzing how, in the face of such problems, improvements in market institutions might be undertaken by buyers, sellers, and "third parties" such as the state.

INSERT TABLE 3 ABOUT HERE

Space does not permit an claboration of these many categories. Elsewhere, where they are dealt with in detail,[35] I stress two summary that are germane to our discussion.

First, each of these categories of "solutions" entails costs as well as benefits, and often the former will outweigh the latter. There is no presumption that intervention in malfunctioning markets will necessarily improve them. In the long run, better markets will be enabled by the improvement of the conditions that underlie the market failures--in particular, better property rights and legal systems, and the widespread availability of relevant information coupled with the ability of individuals and firms to process it.

Second, better markets demand better states. But states themselves "fail." It behooves the advocate of better market institutions simultaneously to ask how government institutions might also be fortified. It is to this question that we now turn.

[35] This framework is derived, explained, and illustrated with case studies from Pakistan and India in Witgaard, *Adjusting to Realit*, *chs. 3-5.*

4. Improving Government Institutions

Market institutions often display shortcomings, especially in the difficult environments faced in poor countries and regions. But so do "non-market institutions" such as development banks and government agencies. The succcssful case of rural credit in Indonesia can be illuminated through the economic analysis of non-market failure.

The first part of the Indonesian story concerned "getting prices right" at the macro level: allowing interest rates to be high enough that banks could make a profit. But this step was not enough:

> While the opportunity for BRI [the Indonesian People's Bank] to make a profit is undoubtedly stronger institutional motivation than simply being acclaimed as an "agent of development," it would be naive to assume that this profit opportunity alone would motivate all of BRI's employees to carry out their duties enthusiastically and effectively and thereby make the program a success. For the goal to be reached, it would be necessary to devise a set of incentives and sanctions that would induce BRI employees at all levels to work hard to achieve the overall objective.

Local banking units were given authority over loans. Accounting reforms at the village level provided realistic information. Cash management rules were liberalized. Training took place. But most important, "Village unit staff memebers were given the opportunity to earn a cash incentive payment . . [which] was geared to the profitability of the unit and its success in attracting savings.

The results were remarkable. Volume more than tripled in three years to over $3 10 million. After losing money in its first year, the new program became profitable, and three years later 82 percent of village units were operating at a profit.[36]

This and other recent experiences demonstrate that government institutions can be improved, and doing better in this domain is becoming a key priority in economic development for the 1990s. In the wake of the free market reforms that have spread throughout the world in the past fifteen years, the state intervenes less in the economy, but it does not disappear. Government remains a principal actor in macroeconomic policy

[36] Donald R. Snodgrass and Richard H. Patten, "Reforms of Rural Credit in Indonesia: Inducing Bureaucracies to Behave Competitively," Development Discussion Paper No. 3 15 (Cambridge, MA: Harvard Institute for International Development, November 1989), pp. 29, 43-4, 49, 52.

making, infrastructure, and social programs--not to mention defence, justice, and foreign policy. Success&l markets themselves require the highly skilled public management of the privatization process, new efforts to protect the environment, policies that promote and protect competition, and the sophisticated regulation of capital markets, banking systems, and decreasing cost industries. For the institutions of free markets to work, government institutions must also work.

Once upon a time applied economists jumped quickly from discerning a market failure to calling for state intervention. As Joseph-Schumpeter once pointed out, the faith of many economists in the benevolence and competence of the state was touchingly naive.[37] No longer. Much recent theorizing in economics, and certainly the prevailing mood among those practicing economics around the developing world, has been much less credulous, Indeed, even the economists who show why untrammeled competition seldom leads to optimality are usually quick to point out that governments cannot be counted on to do better.[38] Markets fail, especially when information is scarce and ignorance widespread, as it is in most developing countries. But states also fail, perhaps especially so under those same conditions. So what to do?

Given the strength of opinions about appropriate economic roles for the state, I find it remarkable that international econometric evidence can say so little about the kinds of government interventions that lead to growth.[39] The theoretical literature is also

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[37] "It still remains true," Schumpeter wrote in 1949, "that a large majority of economists, when discussing issues of public policy, automatically treated political authority and especially government in the modem representative state as a kind of deity that strives to realize the will of the people and the common good . . . Policy is politics; and politics is *a very* realistic matter. There is no scientific sense whatever in creating for one's self some metaphysical entity to he called 'The Common Good' and not a less metaphysical 'state,' that, sailing high in the clouds and exempt from and above human struggles and group interests, worships at the shrine of that Common Good. But the economists of all times have done precisely this." Joseph A. Schumpeter, "The Communist Manifesto *in* Sociology and *Economics," Journal of Political Economy,* Vol. 57, No. 3 (June 1949), pp. 205-6.

[38] See, for example, George A. Akerlof, "The Market for 'Lemons"', esp. p. 488; Joseph E. Stiglitz, "Information and Economic Analysis: A Perspective," *Economic Journal, Supplement,* Vol. 95 (1985), esp. pp. 27-8; Joseph E. Stiglitz, "Markets, Market Failures, and Development," *American Economic Review Papers and Proceedings,* Vol. 79, No. 2 (May 1989), esp. p. 202; David M. Newbery, "Agricultural *Institutions* for Insurance and Stabilization," *in The Economic Theory of Agrarian Institutions,* ed. Pranab Bardhan (oxford: Clarendon Press, 1989), esp. pp. 294-5.

[39] For a review and many references, see a companion to this paper, Robert Klitgaard, "Do Better Polities Lead to Economic Growth?" unpublished ms., May 1994.

inconclusive.[40] We must add other sorts of insight and evidence. In particular, I suggest we draw insights from the economics of information and simultaneously look at efforts around the globe to make the institutions of government function more justly and effectively. Apparent success stories deserve special attention.

Just as the informational perspective provides insights into the problems of markets in developing countries, so too does it suggest approaches to many classic problems of government, such as weak incentives, corruption, personnel selection, decentralization, administrative integration, and executive-legislature relations. In each case, imperfect information exacerbates underlying difficulties. In each case, better information is part of the solution.

Space permits two suggestive illustrations: improving incentives and controlling corruption

Incentives

A crisis of public sector incentives plagues many poor countries. Real wages have fallen and been compressed in ways unimaginable in the industrialized countries.[41] Pay and performance are virtually unconnected. It should be no surprise to an economist,

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40 To limit this vast point to two recent reviews:

When is private-sector production of a good or service to be preferred to public-sector production? "As the empirical debate is far from being settled, we do not think that economists have yet brought a convincing and definite analysis of the relative advantages of public and private production." B. Caillaud, R. Guesnarie, P. Rey, and J. Tirole, "Government Intervention in Production and Incentives Theory: A Review of Recent Contributions," *RAND Journal of* Economics, Vol. 19, No. 1 (Spring 1988), p. 23.

According to a leading World Bank economist, what is known about the effects of economic liberalization? "The links between policies and objectives are complex, with large gaps in knowledge on both theoretical and practical grounds . . . It has to be recognized that the analytical basis for some micro policies in an adjustment program is relatively weak. The theory underlying the effects of eliminating distortions (real and financial) is not well suited to policymaking . . For example, whether removing consumer subsidies will raise overall efficiency and production is still an open question; the same is true of a devaluation. Even on the macroeconomic front, some serious theoretical and empirical issues are still unresolved. . [F]or example, . . the effects of fiscal policy on demand are ambiguous. . . Finally, and perhaps most important, there is still much to be learned about what drives growth in developing countries and in particular about the relationship between short-run stabilization policies and long-run growth." Mohsin S. Khan, "Macroeconomic Adjustment in Developing Countries: A Policy Perspective," *World Bank Research Observer,* Vol. 2, No. 1 (January 1987), pp. 37-8.

41 Robert Klitgaard, "Incentive Myopia," *World Development,* Vol. 17, No. 4 (April 1989)

then, that "non-market failures" are widespread and that efforts to transplant Western management systems without appropriate information and incentives have largely failed.

A South African example concerns agricultural extension. Both market and non-market failures are likely to be present. The market failure concerns the public good nature of research and technical information, for which, private markets supply an insufficient amount. The non-market failure concerns the optimal structuring of jobs, monitoring, and incentives in a bureaucracy, so that "agents", such as agricultural extension agents, pursue the interests of the farmers and their country. For example, some part of agents' pay should be linked to the success of the farmers they serve in using new technologies. Another example involves the creation of incentives for and channels of a two-way flow of information from the researcher to the farmer, but also from the farmer to the researcher, via the extension agent. My student Josephine Blevins has investigated two extension schemes in KwaZulu, one in the public sector where she finds incentives for agents almost entirely lacking and the other in the private sector, where agents are paid in part based on how well their farmers do. Preliminary evidence indicates that the second scheme works much better.[42]

Reforming public sector incentives is not easy. But recent experience shows that by creatively applying economic principles, better government results. I have described some examples in my book *Adjusting to Reality*. Here are a few of the many suggestions that emerge:

1. Work with public employees and citizens to redefine the objectives their agencies should seek.

2. Generate multiple if imperfect measures of how well these objectives are being achieved in practice. A remarkable variety of direct and indirect mechanisms have been employed, including many forms of client participation.

3. Link part of the compensation of public officials to these achievements.

4. Begin with experiments rather than incentive "master plans," and be ready to adapt as lessons are learned.

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42 Josephine Lynette Blevins, "Improving Information and Incentives in Agricultural Extension for Poor People in the Case of KwaZulu," unpublished honours thesis, University of Natal, Pietermaritzburg, 1992.

5. Institute user charges, even when theory says they are less than optimal, because of their dynamic effects in providing information and their ability to relax binding budget constraints on incentive experiments.

"Efficient organizational design"' writes Paul Milgrom, "seeks to do what the system of prices and property rights does in the neoclassical conception: to channel the self-interested behavior of individuals away from purely redistributive activities and into well-coordinated, socially productive ones."[43] In books such as Milgrom's and John Roberts', we see advances in the practical application of the "new" theory of the firm to practical problems of making non-market institutions work better.[44]

Corruption

The perception of corruption in South Africa seems to be large and growing; yet little is said about how to reduce it. In this combined phenomenon South Africa is not alone. Yet recent work on the economics of corruption tends to demystify the topic and, more importantly, suggests practical rules for controlling it, if never eliminating it entirely. Once again key contributions come from applying the economics of information.[45]

One possible starting point is a principal-agent-client model. The agent uses his office for private benefit when he calculates that the benefits from doing so (the bribe) outweight the likely costs (ii particular? the probability of being caught and punished times the penalty). The principal's problem is to influence this calculation in such a way that the agent provides the optimal amount of public service and the optimal amount of corruption, (Because preventing it is socially costly, the optimal amount of corruption, like pollution, is not usually zero.) The principal can take a variety of steps that the model enables us to group into five categories:

1. Selecting agents.

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[43] Paul Milgrom, "Employment Contracts, Influence Activities, and Efficient Organizational Design," *Journal of Political Economy,* Vol. 96, No. 1 (February 1988), pp. 58-9.
[44] Paul Milgrom and John Roberts, *Economics, Organization and Management* (Englewood Cliffs, NJ: Prentice-Ha& 1992).
[45] See, for example, Jean Tirole, "Persistence of Corruption," IPR55, Working Paper Series, (Washington, DC: Institute for Policy Reform, October 1992); Paul Milgrom and John Roberts, "An Economic Approach to *Influence* Activities *in* Organizations," *American Journal of Sociology,* Vol. 94: S 154-S 179 (1988); Susan Rose-Ackerman' *Corruption (New* York: Academic Press, 1978); Robert Klitgaard, *Controlling Corruption* (Berkeley and Los Angeles: University of California Press, 1988).

2. Changing positive and negative incentives facing agents, based on their efforts and achievements.

3. Collecting and processing information on agents' efforts and achievements (and in some cases on the agency's clients).

4. Restructuring the agent-client relationship--for example, to induce competition or clarify the rules of the game.

5. Try to influence the perceived moral costs of corrupt behavior.

The problem quickly becomes too complex for formal optimization, but perhaps that is not the ideal for policy analysis. Instead, in my consulting work, I have found that clients' own creativity is spurred by acombination of (1) case studies of success and (2) a detailed framework for policy analysis that helps them think through the issues systematically.[46] The very fact that such a sensitive subject is approached through economic analysis (instead of, say, ethical theory, cultural analysis, or the law) is to many people the source of great creative stimulation.

For markets to work well, government must work well. And for government to work well, more is needed that multiparty democracy, welcome as this is. Especially in the difficult environments found in developing countries, governments are hampered by poor information and incentives, which in turn are important factors behind inefficiency and corruption. Economic analysis and experience in other countries suggests that South Africa will need to counteract these problems in order to succeed.

5. Addressing Group inequalities

So far we have emphasized some features South Africa shares with other countries: the problems of making new policies credible, and the difficulties of fortifying the institutions of market and state. In this section and the next, we examine ethnic inequalities and identities, a problem that also faces many other countries but where South Africa's legacy is qualitatively different. The separate development of racial groups was officially embodied in South African law and policy as nowhere else, in recent years, in the world. It is the prospect of transcending official racism, somehow creating a free and just

[46] For a discussion both of this aim in policy analysis and of the detailed framework for anti-corruption policies, see Robert Klitgaard, "Gifts and Bribes," in *Strategy and Choice,* ed. Richard J. Zeckhauser (Cambridge: MIT Press, 199 1).

order from a glaringly unjust one, that makes South Africa a special case--not only in Africa, and not only in the 1990S, but in human history.

In this transition what needs to be done? It is a provocative exaggeration to put it this way, but two approaches seem to dominate. The first says, "Get rid of all racist policies and legacies and proceed as in a normal country." The second says, "Redistribute through compensatory public spending and taxation (including land reform and wealth taxes), subject to contraints concerning macroeconomic stability and growth." We might call these two the "usual suspects" in mainstream discussions in South Africa.[47]

These are important issues to be sure, but this paper has been suggesting a different, or perhaps better put, a further approach. We should delve below macroeconomics and examine the institutions, both public and private, that affect the poor in South Africa. We should go beyond debates over state vs. market and consider how both state and market can be made more efficient for the disadvantaged and oppressed. The economics of information can provide practical insights into better states and better markets.

Let us pursue these themes with regard to ethnic inequalities, by examining how discriminatory labor markets might be improved, including the role of affirmative action.

Jobs

South Africa is categorized as an upper-middle income developing country with a per capita income of about $2600. Average figures hide a lot, even more in South Africa than in most other poor countries. By several measures South Africa's income distribution is the most unequal in the world.[48] Racial inequalities are particularly pronounced. The per capita income for whites is 9.5 times that of black South Africans, 4.5 times that of "colored" or mixed race South Africans, and 3.0 times that of South Africans of South Asian origin.49 To put this in perspective, in the late 1980s United States white incomes were 1.6 times that of blacks, and in the late 1970s in Brazil whites earned about 2 times

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47 I leave out Marxist and related approaches, not because they lack importance but because in the current economic debate they seem to he confined to historical and current description and, curiously, to be less explicit about Policies that ought to he pursued. But this impression may be an artifact of my limited reading and contacts.

48 Among 57 countries for which the Gini coefficient is available, South Africa's is the highest. Francis Wilson and M. Ramphele, *Uprooting Poverty: The South African Challenge* (Cape Town: David Philip, 1989).

49 Fallon, *et al.*, "South Africa: Economic Performance and Some Policy Implications," draft (Washington, D.C.: The World Bank, Feb. 18, 1993), p. 22.

as much as the combined average of blacks and *pardos* ("browns," or people of mixed race).[50] And notice the tremendous disparities within South Africa. In 1985 the per capita income of blacks in the Transvaal was estimated to be 6.3 times that of blacks in the Transkei.[51]

Part of South Africa's inequalities is a direct legacy of apartheid, in the sense of reserved jobs and restricted residence, disproportional investment in white human capital, and so forth. Other sources may include the "tastes" of those making decisions (in the sense of racial dislike and hatred), statistical discrimination, inefficient labor markets, and differences in human capital. Econometric studies elsewhere have been unable to quantify persuasively the magnitudes of various sources of ethnic inequalities.[52]

We can, however, begin to get a feel for wage inequality versus job inequality in South Africa. Unemployment and underemployment are high and growing, although data are hard to interpret. In 1990 the total estimated of employed people, including agriculture and domestic service, was 7.95 million, almost 60 percent of the economically active population of 13.42 million. From these data come the often-heard figure of 40 percent unemployment. Those not in formal employment, however, include people in subsistence agriculture, the self-employed, and the unemployed. According to 1991 Census results, as yet unadjusted, 1.94 million people in South Africa (cxcludmg the TBVC states) were actively seeking work.. This was about 19 percent of the economically active population. Another 7 percent were self-employed, and 74 percent were classified as employed.[53]

Among the employed there are tremendous racial disparities. Figure 2 shows job and wage inequalities among blacks and whites in a 1991 survey of 222,620 employees in South Africa (Peromnes Survey on Remuneration). In this non-random sample, about 41 percent were whites, 45 percent blacks, 10 percent coloured, and 4 percent Asian. Employees are classified into 19 grades: l-3, top executive and the most senior specialists; 4-6, senior management and high-level specialists; 7-9, middle and lower

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[50] Klitgaard, *Adjusting to Reality,* ch. 10.

[51] Fallon *et al.,*. p. 24.

[52] T. Paul Schultz, "Labor Market Discrimination: Measurement and Interpretation," in *Unfair Advantage: Labor Market Discrimination in Developing Countries,* ed. Nancy Birdsall and Richard Sabot (Washington, D.C.: The World Bank, 1991).

[53] Edward Osborn, "The Mythology of Macro-economics," *Nedbank Quarterly Guide to the Economy,* February 1993.

management, superintendents and lower-level specialists; 10- 12, supervisors and high-level skilled and clerical staff; 13-16, lower-level skilled and clerical staff; and 17-19, very low-skilled and unskilled workers. The classification of a particular job depends on eight criteria, each of which is rather subjectively estimated.[54]

INSERT FIGURE 2 ABOUT HERE

Figure 2 contains good news and bad news. The wage gap given jobs is relatively small. A regression analysis by my student Christopher Wostenholm finds that on average blacks earn 11 percent less than whites of the same gender in the same job grade. This earnings gap given jobs has dropped over time.[55] Earlier estimates using Peromnes data were 47 percent (1976), 24 percent (1985), and 20 percent (1989).[56] There has been progress.

But the distribution of jobs by race remains remarkably unequal. Very few blacks have penetrated into supervisory and managerial jobs. What might public policy do to accelerate a more equal distribution of jobs?

To this question the "usual suspects" mentioned earlier present familiar and useful suggestions. The first says, "Withdraw all apartheid rules and enforce equal opportunity." The second adds, "Spend more state money on preparing black people for higher-level jobs."

The approach we have been pursuing poses further questions. Why might the job market not be working well for blacks, and what might the government do to improve it? In particular, how might information problems about the quality of labor be overcome?

Real labor markets often malfunction because of poor information, sticky wages, and transactions costs involved in hiring and firing. It is costly and uncertain for employers to find and evaluate employees, and vice versa for employees. Marginal

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[54] The criteria were, in the words of Peromnes, problem solving, consequences of errors in judgement, pressure of work, job-impact, knowledge, comprehension, educational qualifications or intelligence required, and subsequent training and experience.

[55] Christopher Wostenholm, "The Trend of Employment and Wage Discrimination in South Africa," unpublished honours thesis, University of Natal, Pietermaritzburg, 1992.

[56] John B. Knight and Michael D. McGrath, *The Erosion of Apartheid in the South African Labour Market: Measures and Mechanisms*, Applied Economics Discussion Paper No. 27, oxford University Institute of Economics and Statistics, 1987; Susan Allwright, "An Analysis of Wage Trends in the South African Labour Market, 1976-1989," unpublished honours thesis, University of Natal, Pietermaritzburg, 1989.

products are difficult to discern, and information about them is asymmetrically held. As a result, wages are difficult to adjust for individuals. Quitting and firing are at best traumatic, at worst impossible. Under these conditions, which economists are taking more and more seriously in theory and practice, a wide variety of seemingly "inefficient" labor practices are adopted by profit-maximizing employers and employees, including internal labor markets, wage/experience profiles that start below and then rise above the employee's marginal product, and institutionalized discrimination.[57]

Now add in the further labor market imperfections stemming from racial inequalities. Around the world we have learned that one source of racial and gender discrimination is informational.58 We tend to stick with what we can readily find and assess, which turns out to be people from our own backgrounds and localities.

In the face of such problems, governments might undertake several sorts of actions, such as promoting labor laws that encourage wage flexibility and facilitate hiring and firing. I wish to emphasize a sometimes overlooked point: since information is part of the problem with labor markets, information should also be part of the solution.

Generating, Diffusing, Certifying Information

Many sorts of information are public goods, meaning that private firms will tend to underprovide them. Government programmes can help. The state can help develop measuring instruments for actual and predicted performance on various kinds of jobs. It can create computer job banks and public employment offices. In general, it can help private parties overcome problems of the credible provision of information about productivity.

But notice that often the state's comparative advantage may not be in the actual provision of information but in funding, guaranteeing, and sometimes requiring its provision by private actors. Many sorts of information are probably best developed by private firms themselves, perhaps working in tandem, urged on by government policies.

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[57] A useful text *is* Milgrom and Roberts, *Economics, Organization and Management*, esp. chs. 10-13.

[58] For a recent review, see Andrew Foster and Mark Rosenzweig, "Information Flows and Discrimination *in* Labor Markets in Low-Income *Countries," Proceedings of the World Bank Annual Conference on Development Economics,* 1992 (Washington, D.C.: The World Bank, *1993).*

Information and Affhative Action

The informational perspective sheds new light on affirmative action programs Let me suggest two examples.

1. Creating new internal markets and information flows. Who is likely to be better at discovering and selecting the right employees, the government or the private sector? I'd bet on business--but only if business has sufficient incentives to find good workers from disadvantaged groups. The incentives can be positive and negative. Affirmative action is one mechanism to induce the private sector to create information flows across racial groups and subregions, which apartheid and other factors have discouraged. This will cost the private sector something, but the net social costs will probably be less than if government tries to work alone. Affirmative action can be subsidized as well as mandated, exploiting the private sector's competitive advantages in developing labor markets.

2. Overcoming misperceptions. Apparently, many blacks in South Africa perceive capitalism as the enemy. Big business has not solved their problems, and it has remained the domain of the whites. Without a strong and immediate effort to incorporate them throughout the private sector, many blacks may misperceive the business world, leading to hostility at best and nationalisation at worst.

In this dangerous context, affirmative action offers several informational advantages. First, it immediately brings more blacks into the "white" private sector. From new vantage points inside the system they will see how modem businesses really work, learning about capitalism's true shortcomings and strengths while unlearning many pernicious myths and superstitions.

Second, by working alongside whites and Indians, blacks will learn more about their own skills relative to these other groups. They will find out they can do some things better than they have been told they could, and some worse. They will also find out that those who succeed are really good, not just really privileged.

Third, even those who do not benefit directly from preferential treatment will perceive that the system has changed, that. exclusion is over, that there *is* nut a silent conspiracy against them. Affirmative action provides credible transparency in a suspect system.

Learning about efficient organization, meritocracy, and entrepreneurship is essential, and South Africa cannot wait for a generation or two for its disadvantaged members to grasp the message and the culture of business achievement. A crash course is needed. Strong affirmative action is one of the ways.[59]

How Much Affirmative Action?

Remarkably, many discussions of preferential treatment in labor markets pose the problem as a yes-no question: should we or should we not give extra weight in hiring to members of certain groups? "Affirmative action is a failed policy," one side says, as if success and failure were binary. "It contravenes the principle of merit, it is inefficient, and [less often declared] it may hurt me, my people, and my organization."

"Affirmative action is required justice," the other side avers, as ifjustice were a simple switch with an on-and-off indicator. "We must have retribution and redistribution, and affirmative action helps both objectives and [less often declared] also helps me and my people."

The resulting debate is seldom illuminating. Can we do better?

In two books on selection policies, I have argued that we should employ the same analytical rigour on afiirmative action that we do on economic policies of many kinds.[60] Using detailed examples from China, Malaysia, Indonesia, the Philippines, and the United States, I suggest that the issues are multidimensional and questions of degree. Using mathematical models, I show that the optimal extent of affirmative action does not depend only on one's ethical views, but also on specific attributes of the particular decision setting. For example: the exact statistical relationships between various selection criteria and later performance, the proportions of various groups in the applicant pool, the ratio of openings to applicants, the differences among group distributions of the various selection criteria, the "utility function" for later performance, and the "utility function" for various degrees of representation of groups among those selected.

Let me suggest a few qualitative results relevant to South Africa's problems. First, the costs of affirmative action will in general be higher here than in the United States. For one reason, predictors of job performance such as measured intellectual ability in the

59 Without being sensationalist, another reason to institute strong affirmative action is to create stakes. If not now then in a few years, influential leaders may suggest that the system is still the same, that the way to ensure justice is for the state to take over more and more private businesses. This argument for nationalisation will be harder to make and to sell if affirmative action puts more blacks at all levels of the private sector.

60 *Elitism and Meritocracy in Developing Countries* (Baltimore: Johns Hopkins University Press, 1986), and *Choosing Elites* (New York: Basic Books, 1985).

psychologist's sense are more unequally distributed here than in America. Based on many studies, a reasonable guess of the gap between mean black and white intelligence is a little more than one standard deviation in the United States and almost two standard deviations in South Africa. Moreover, blacks comprise a much higher percentage of the relevant applicant pools in South Africa. Other things equal, this means that the marginal cost in terms of predicted performance of taking one more black and not taking the marginal white will be higher here.

Second, the costs of affirmative action are less when wages are flexible and when hiring and firing is inexpensive. The analogue in universities: when measures of performance are continuous rather than binary, and when admission and flunking out are inexpensive. Institutional changes in these dimensions will reduce the costs of aggressive preferential treatment.

Third, there is no one "right" degree of affirmative action, holding constant one's ethical or political "utility function" for a greater representation of blacks. The trade-off depends on the particular situation, as mentioned above, including how well one can predict with partial and imperfect information the later performance of those hired or admitted.

Finally, incentive or backwash effects are crucial, if difficult to measure. Some economists have invented models where preferential treatment subverts the incentives of both the favoured and the non-preferred groups.[61] But others have developed models where preferential treatment actually improves incentives for performance for members of both groups.[62] In general the most advantaged members of the disadvantaged group will benefit most from preferential treatment, and in analogy to other forms of preferential treatment for certain producers such as tariffs we can expect rent-seeking behaviour to flourish.

Elementary economics is a poor guide here. We need the sophisticated analysis of particular cases to discover how and how much information and incentives will be swayed by various forms of affirmative action. As South Africa enters a new era where one can

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[61] Stephen Coate and Glenn Loury, "Affirmative Action as a Remedy for Statistical Discrimination," unpublished draft, Kennedy School of Government, Harvard University, October 1990.

[62] Mary O'Keeffe, W. Kip Viscusi and Richard J. Zeckhauser, "Economic Contests: Competitive Reward Schemes," *Journal of Labor Economics,* Vol. 2, No. 1 (Winter 1984).

predict that preferential policies will become increasingly important, we need to become more subtle, analytical, and empirical in our analysis of the ways job markets work.

6. The Intellectual and Practical Challenges of Cultural Diversity

At the outset of this paper I mentioned a constellation of phenomena that seem around the world to accompany the putative liberation of heretofore disadvantaged groups. Regarding the surprising and increasing psychological discomfort surrounding the disadvantaged, my suggestions are even more schematic and tentative. Philosopher Charles Taylor of McGill University writes of "the politics of recognition." What oppressed or stigmatized groups grow to desire as much as or more than equal political and economic opportunities are respect, recognition, dignity.

Symbols of recognition matter. For this reason I believe affirmative action deserves special emphasis. Not because I underestimate the static and dynamic costs of giving preference to those with less preparation and ability, because these can be substantial; and not because I believe that international experience can readily provide examples of preferential programs with rapid and sustainable results.

Rather, it is because politically as well as economically, not only in South Africa but especially here there is a need for the expiation of sins coupled with a kind of forgiveness, to require retribution as well as redistribution. Blacks have many reasons to distrust what they see as a racist economic system. Even when the overtly racist features are removed, their legacy, plus the disadvantages that blacks around the globe experience vis-a-vis other racial groups, mean that without special measures closing the gap will be slow. Affirmative action can accelerate this process; moreover, it promises to create transparency in economic systems and structures, by putting black people at all levels of responsibility. The benefits in terms of symbolic and actual credibility, of symbolic and actual changes in the former exclusionary rules of the game, seem likely to outweigh the undeniable costs in terms of per unit costs of and/or quality of production.

Beyond affirmative action there are many other policies to promote respect and recognition, which go well beyond the important questions of how efficiently to design educational systems, housing programs, pension systems, and schemes of urban and rural development. The mandated mixing of the races may, in the first instance, be a beneficial symbolic step, as when de facto exclusionary schemes of schooling and housing are forcibly redressed. Later, if experience in places such as the United States are germane, the politics of recognition may entail the possibility of providing choices for culturally homogeneous schools or settlements or even investment banks. Throughout, the politics of recognition may involve the uplifting, even the "overemphasis," of heretofore disadvantaged cultural manifestations.

These actions carry costs. They also may foster intellectual no-fly zones. In the United States in my experience the-symptoms have included the suppression of unpleasant or unpopular research findings, ranging from evaluations of prison reforms to schooling programs to data about crime, tax evasion, sexual behavior and disease, child beating, and psychological instability. Research on some subjects involving ethnic inequalities is ostracized. Indeed, discourse about group differences and similarities, about the characteristics and quality of different cultural traditions, may be rendered impermissible.

This is unfortunate, not only for intellectual freedom but, I believe, for future progress on ethnic inequalities and identities. When the problems are the most difficult, as these no doubt are, is when we need more intellectual work and more impassioned cultural creation, not less. But can we overcome inequalities and promote recognition and respect at the same time as we probe sensitive areas, risk hurt feelings, examine the bases of identity? Of all the challenges facing South Africa, and perhaps the world, doing both these things seems to me the greatest.

My own thoughts and emotions on this matter are still raw. My hope is that social scientists, especially those who know or whose disciplines allege to know something about group differences, should play a leadership role, not only in South Africa but around the world. But only if we change: to play this role, social scientists must become more like soil scientists.

Analyzing Cultural Differences

My hope is not groundless. Today, in a variety of disciplines we see exciting intellectual advances concerning what might be called "sociocultural factors" in economic and political development. For example:

- The rigorous documentation of the importance of civic cultures to the quality of government in Italy.[63]

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[63] Robert Putnam, *with* R. Leonardi and R.Y. Nanetti, *Making Democracy Work: Civic Traditions in Modem Italy* (Princeton: Princeton University Press, 1993).

- The combination of qualitative and quantitative methods to show that the "fit" between traditional institutions and modern structures distinguishes "successful" and "unsuccessful" Native American reservations.@
- The demonstration using anthropological research that minorities' self-definition plays a strong role in determining their academic success.65
- The successful testing of a new "cultural theory" to help explain attitudes toward risk the management of resources, and strategies for overcoming poverty.6
- The application of market research techniques, in combination with anthropological data-gathering, to problems of rural development.[67]
- New studies of African success stories that emphasize the roles of indigenous institutions.[68]
- One of the first applications of the cross-cultural information in an anthropological "data bank" to a practical problem of development policy.[69]
- New efforts to apply sociocultural knowledge in the work of development agencies.[70]

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[64] Among many papers, see Steven Cornell and Joseph Kalt, "Reloading the Dice: Improving the Chances for Economic Development on American Indian Reservations" (Cambridge, MA: Kennedy School of Government, March 1992).
[65] For example, John Ogbu, *Cultural Models and Educational Strategies of Non-dominant Peoples, (New* York City College of New York, 1992).
[66] M. Thompson, R. Ellis, and A. Wildavsky, *Cultural Theory* (Boulder, CO: Westview, 1990); Karl Dake, "Myths of Nature: Culture and the Social Construction of Risk," *Journal of Social Issues,* 48:4 (1992).
[67] For example, T.Scarlett Epstein, *A Manual for Culturally Adapted Market Research (CMR) in the Development Process* (Bexhill-on-Sea, UK: RWAL Publications, 1998).
[68] For example, *the many studies* described *in* Africa Technical Department, *Indigenous Management Practices: Lessons for Africa's Management in the '90s, Work Program and Methodology* (Washington: The World Bank, May 1993); Mamadou Dia, "Indigenous Management Practices: *Lessons* for Africa's Management *in the* '90s," *in Culture and Development in Africa*, Vol. I, ed. I. Serageldin and J. Tabaroff (forthcoming).
[69] S. Romanoff, S. Carter, and J. Lynam, "Cassava Production and Processing in a Cross-Cultural Sample," unpub. ms, December (New Haven, CT: Human Relations Area Files, 1991).
[70] For example, Michael Cernea, "Knowledge from Social Science for Development Policies and Projects," *in Putting People First: Sociological Variables in Rural Development,* ed. M. Cemea, 2d *ed. (New* York: Oxford University Press, 1991); *The Socio-Cultural Dimension in Development: The Contribution of Sociologists and Social Anthropologists to the Work of*

In addition, new empirical studies rigorously demonstrate the importance of corporate cultures to business performance[71] Some economists have been analyzing the emergence and importance of norms and social institutions,72 including the **co-winner** of the 1993 Nobel prize, Douglass North.[73] One is witnessing what might be called a renaissance of applied sociocultural studies.

Nonetheless, within and across academic disciplines there are many obstacles to more rigorous and more practical work on sociocultural variables. Academic identities are sometimes at stake. It can become a battle of disciplinary virtue to maintain for example, that cultural differences are unimportant once economic factors are correctly understood, or that culture should not be reducedto a set of variables but should be considered a holistic *fait sociale totale* (Marcel **Mauss). These** battles can resemblc intercultural conflict, full of stereotyping, turf-protecting, and failures to communicate. Other obstacles include the (warranted) fear of misuse of cultural information, the sheer statistical difficulty of modeling and estimating interaction effects, and a misguided idea of policy analysis. There may also need to be a reconceptualizing of the objectives of sociocultural studies.[74]

Becoming More Like Soil Scientists

To avoid these crippling obstacles to progress, we must redefine our mission--and **change our concept of what it is that "social science"** might contribute.

"Culture" is a concept of notorious breadth and vagueness. It refers to an assemblage of beliefs, attitudes, institutions, and practices that imperfectly but significantly distinguish one group of people from another and are passed on, imperfectly but

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Development Agencies, ed. M. Schönhuth, Sonderpublikation der GTZ, No. 249 (Eschborn, Germany: Deutsche Gesellschaft für Technische, 199 1).

71 For example, John P. Kotter and James L. Heskett, *Corporate Culture and Performance (New* **York: Free Press, 1992).**

72 For example, Robert Sugden, *The Economics of Rights, Co-operation and Welfare,* oxford: Basil Blackwell, *1986); Andrew* Schotter, *The Economic Theory of Social Institutions* (Cambridge: Cambridge University Press, 198 1).

73 For example, Douglass *C. North, Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990).

74 **Robert Klitgaard, "Taking Culture into Account: From 'Let's' to 'How'," in** *Culture and Development in Africa,* Vol. I, ed. I. Serageldin and J. Tabaroff (Washington: The World Bank, 1994).

significantly, from one generation to the next. In Robert Putnam's phrase, culture is the *symbolic* soil in which institutions are planted.

Let us pursue Putnam's analogy. What do soil scientists do? They analyze soils, using partial and incomplete measures of soil differences. Their typoiogies and empirical results do not pretend to "capture" or "summarize" a soil area, and good soil scientists listen carefully to what local farmers know about their land. Soil scientists help farmers make decisions about (1) what crops to grow given local soil conditions and (2) what soil treatments to undertake (e.g., fertilizer, cropping patterns, irrigation, etc.) Beyond just describing differences in soil conditions, soil scientists study the *interactions* among soil types, crops, and soil treatments.

Perhaps students of society and culture might spend more of their time emulating soil scientists. We, too, might seek to provide *partial and incomplete* measures of local sociocultural conditions in order to *help local people* make better decisions. As in the case of soil science, one idea is to choose appropriate "plants" to take advantage of given "soils"--in this case, selecting policies and institutions to take advantage of local sociocultural strengths and minimize their weaknesses. But also as in the case of soil science, another idea is to help local people change the soil conditions. Sociocuitural studies should have as one goal the improvement of local choice through a better understanding of how to take cultural conditions into account and how to change them.

Being more like soil scientists is an aspiration that is at once bold and modest. Its boldness comes from its taking social science seriously, and trying to apply it. Modestly, it eschews any illusion of "capturing" or "summarizing" a culture through research. As with soil scientists, the aim should be to help local people make up their own decisions with the aid of both local and cross-cultural knowledge. The metaphor has a further advantage. It suggests there are virtues to getting our hands dii and keeping our feet on the ground.

What kinds of research does this perspective recommend? Guided by the soil science metaphor, we should try to understand what classifications of sociocuitural "soil conditions" might prove useful, for which questions and in what settings. We should ask what intellectual tools might be used to assess local soil conditions. We should donsider how the knowledge thus obtained, necessarily incomplete and imperfect, might be used and misused, by local people themselves, by policymakers, by intellectuals.

An important goal is to suggest ways that new theoretical and empirical research might illuminate the interactions among cultural variables, policy variables, and the local environment in producing various economic, political, and social outcomes. Or more briefly: to explore how we all might become better soil scientists in the sociocultural domain.

I believe this approach has two potential benefits. First, it may help all of us "take culture into account" in practical decisionmaking. Second, by examining culture's different dimensions, its coverage and exceptions, its power and its mutability, all in the down-to-earth fashion of soil scientists, perhaps all of us will be helped to be more understanding and appreciative of the inevitable intertwining of similarity and difference.

7. Recapitulation

Many recent discussions of economic policies in South Africa focus on macroeconomic matters and the role of the state in running the economy.[75] The World Bank has weighed in with an impressive series of discussion papers.[76] In January 1994 the sixth draft of the ANC/Cosatu economic program has been announced in the press. To the surprise of many observers, these various documents contain much in common. They emphasize "sensible" macroeconomic policies with a key role given to market forces and the private sector. They also emphasize the need to redress past injustices against disadvantaged groups, stressing what I have called the two usual suspects: getting rid of discriminatory policies and engaging in redistributive public spending that favors disadvantaged groups.

There is much to laud here--and also in the apparent commitment of most parties in South Africa to a future democratic order based on limited powers and multiple parties. Yet experience elsewhere warns that these steps will not be sufficient. Beyond political

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[75] *See,* for example, *State and Market in Post Apartheid South Africa*, ed. Merle Lipton and Charles Simkins (Johannesburg: Witswatersrand University Press, 1993); *Redistribution: How Can It Work in South Africa?*, ed. Peter Moll, Nicoli Nattrass, and Lieb Loots (Cape Town: David Philip, 199 1); *Transforming the Economy: Policy Options for South Africa*, *ed.* Graham Howe and Pieter le Roux (Durban: Indicator South Africa, 1992); Walter E. Williams, *South Africa's War against Capitalism* (Kenwyn, South Africa: Juta & Co., 1990); *The Mount Grace Papers: The New Public Administration Initiative and the Mount Grace Consultation,* ed. Anne McLennan and Patrick FitzGerald (Johannesburg: Public and Development Management Programme, University of the Witswatersrand, n.d.).]

[76] For example. The World Bank Southern Africa Department, *South Africa: Economic Performance and Policies, Vol. II, Main Report,* draft for discussion only, revised (Washington, D.C.: The World Bank, 24 Nov. 1993).

and economic adjustment at the macro level--the revolutionary move to multiparty elections for all, and the appreciation of the need for market-friendly economic strategies--we are learning that other steps are needed for democracy and free markets to deliver on their promises of justice and efficiency.

Making New Political and Economic Orders Credible

An initial problem concerns the credibility of economic policies and new political orders. Sadly, experience in Africa as well as the former Communist bloc countries shows that even when new orders are declared, investment does not automatically increase. Investors, both local and foreign often find the new rules of the game too uncertain or too unclear, or too poorly enforced, to attract them.

A country can do several things to try to be credible. It can promulgate a constitution, as South Africa has; although in many countries, as in South Africa, a significant majority of the new legislature can change the constitution and in fact have.

A government can promise not to exceed certain parameters in macroeconomic matters. For example, in the ANC campaigning there were some promises that the budget deficit will not exceed 6 percent. Those familiar with campaigns in other countries may wonder how credible such promises are, even when they make sense and are sincerely meant at the time.

A government may commit itselfthrough international agreements. For example, South Africa is entering the General Agreement on Tariffs and Trade, although not fully yet. Another example involves the conditionality usually associated with foreign aid. South Africa's current government and the Transitional Executive Council have agreed to a loan with the International Monetary Fund and will no doubt make agreements after the elections with the World Bank, as well as with bilateral aid donors. In many other countries loans from the IMF and the Bank are conditioned on specific policy measures and sometimes on macroeconomic performance. This helps make the government's own declarations of policies more credible.

But only if all parties know that if the government does not live up to those declarations, aid will be reduced or rescinded. Because conditionality seems to cut against national sovereignty, some critics (and some governments) have vilified it. Within international lending circles, there is a new recognition that conditions simply imposed without "local ownership" are often ignored in practice. And the reality of aid in many poor countries is that it is not cut off even when governments do not fulfill their promises.

This paper suggests that countries such as South Africa, and their foreign supporters, consider new ways to make local commitments more credible. The analogy is to a guarantee where the guarantor does not necessarily enter into the substance of what is guaranteed. Domestic negotiations between disagreeing parties may be facilitated, even made possible, by the prospect of outside guarantees and enforcement of whatever agreements are in fact made domestically. And investors' confidence in a country's declarations may be greatly enhanced if third parties, at the country's behest, can credibly guarantee them.

A comparative advantage of organizations such as the IMF, the World Bank, and the United Nations may be their ability to guarantee, monitor, and enforce agreements and policy declarations--always, to repeat, at the request of the country affected. Existing institutions have the technical capability and credibility to undertake such guaranteeing, monitoring and enforcing. The new South African government should consider creative ways to use international institutions to fortify fragile commitments.

Making Market Institutions Work for the Poor

New work in economic theory and new empirical research help us understand why many markets, even competitive markets, may not live up to expectations in the difficult environments encountered in developing countries and the former Communist countries. When property rights are weak, when information about the quality of a good or service is scarce and asymmetrically held, and when opportunities arise for illicit activities to enable a few firms to exploit market power, markets will tend not to serve those most susceptible to weak property rights, poor information, and exploitation--namely, the poor. This means that public policies are needed that go beyond macro-liberalization and deregulation: policies that improve the environment for well-functioning markets.

We have discussed examples from agriculture and the market for labor. One insight is that information must be improved, about the quality of agricultural products, the quality of credit risks, the quality of land and housing, the quality of workers and jobs. Through a variety of measures, governments can stimulate the private sector and individuals to develop and use better information.

A second insight is that property rights must be better defined and better enforced. Credit and land markets in particular are often handicapped by poor property rights or the lack of enforcement of contracts, a kind of property right. Experience elsewhere also suggests that the successful redistribution of land depends on both good property rights and well-functioning markets for products, inputs, and credit.

What must be done to make markets work better in these ways? First we need to recognize that a problem exists--in particular that the debate should go beyond the state vs. market controversy, and that appropriate economic policies must go beyond the declaration of free markets and redistributive spending. Second, we must undertake detailed studies of markets in South Africa. Third, we must learn from other countries, which have faced and sometimes ameliorated similar problems. Finally, we must experiment, involving the private sector and local institutions, in an effort to discover what institutional arrangements work best in various distinctive settings.

Institutional Adjustment in Government

Around the world, development strategies are shifting from policy reform to institutional reform. As we learn that macroeconomic adjustment does not guarantee economic success, that multi-party democracy is not enough for political success, we begin to focus on the ***institutions*** through which economic and political activity are carried out and mediated. I have suggested that the economics of information provides theoretical and practical insights into the frequent shortcomings of market institutions in developing countries. Theory and example suggest that government action can help market institutions work better. Sometimes, indeed, better markets require better states.

"Better states" does not mean or does not only mean states that spend modestly or states that respect rights. States fail to live up to their own potential because of chronic problems of incentives, corruption, and overcentralization, to name just a few. Noting these problems is not new; what is novel is the increasing and practically useful application of the economics of information and the "new theory of the firm" to the reform of non-market institutions.

The applications are so new that we do not yet have consensus on the labels. One encounters in international agencies and in national governments such overlapping concepts as governance, public administrative systems, institutional dcvclopmcnt, reinventing government, and administrative adjustment. I predict that within five years we will have a more stable set of concepts and "texts" and a "template" to guide reforms in this domain. The principles of institutional adjustment in the public sector will include.:

- Enhance information and evaluation. Put it in the hands of clients, legislators, and those with official oversight (regulators, auditors, judges, etc.).

- Improve incentives. Link incentives to information about the attainment of agreed-upon objectives. In a phrase, institutional adjustment must be incentive compatible.
- Promote competition and countervailing forces--including civil society, the media, the legislature and the courts, and political parties--and procedures that allow these different interests and voices to make a difference in policy and management.
- Launch a systematic campaign against corruption.
- Harden the budget constraint. One possibility is to reduce foreign assistance; another, as Chapter 2 suggests, is to make aid more contingent on performance, including good government.

This approach contrasts with approaches based on more: more spending, more training, more personnel and equipment, more coordination, more central planning, and more technical assistance. My argument is that without institutional adjustment in government, "more" of these things is unlikely to solve the problem of inefficient, corrupt governments in contexts like those found in many African countries. And without better governments, institutional adjustment in markets will lag. Even countries with multiparty democracies and well-designed macroeconomic reforms will find that the rich and the foreigners benefit disproportionately, leaving the poor behind.

In the case of South Africa, these new perspectives on both market and state institutions may not have received sufficient attention. We tend to be preoccupied with "the usual suspects," that is, with calls to get rid of the apartheid legacy and to become (in the words of Mikhail Gorbachev in another context) "an ordinary country," and with calls for redistributional spending by the state. Both points have their merits. But they tend to underemphasize the detailed economic analysis of the way market and state institutions actually work in South Africa, and how to make both work better.

The Dynamics of Group Inequalities

In broaching this complex of subjects, and doing so in the most tentative and humble of fashions, this paper has raised three issues. First, labor markets may, even without apartheid restrictions, tend to perpetuate discrimination, because groups do differ in tastes and capabilities and because individual-level information is scarce and unreliable. Part of the solution is to improve individual-level data on capabilities and actual performance.

Another is to free up restrictions on hiring, firing, promoting, and differential pay, which will reduce the pay-offs to employers from using group information in hiring decisions.

Second, affirmative action has a special role to play in South Africa. Not because it has been efficient elsewhere and not because it will be without significant costs here, but for two other reasons: it will help market-enhancing information to flow, and it will constitute a visible symbol of the end of the old order. The symbolism of redistributional policies is crucial in a situation such as South Afiica's. The visibility of policy measures and their short-term impact on perceptions is crucial. Moreover, a measure of retribution may have to accompany redistribution, in order to make possible atonement and forgiveness. Second-best measures in terms of economic efficiency may have decisive advantages in these other domains.

Third, I suspect that in many countries we need to think more creatively and more concretely about group differences and what it means to be a multicultural society. Based on experiences in other countries, in South Africa we may anticipate that during the next years of transition, people and groups accustomed to well-defined places and roles, even those having many negative aspects, will be unsettled by putative equality. Many victims of former injustices will become less and not more sure of themselves, and the less successful members of disadvantaged groups may end up more subject than before to crime, disorder, and depravity.

In what may be a related development, after disadvantaged groups and individuals achieve a measure of equal rights and opportunities, these same groups and individuals begin to demand a "recognition" that goes beyond univcrsalism--for instance, calls for separate development or the advocacy of culturally attuned education.

Especially in South Africa, the ironies and paradoxes of such trends will be wrenching. At the same time, we can expect that the careful analysis of various group inequalities as complicated functions of history, class, culture, biology, psychology, and geography may become so politicized that new brands of intellectual squeamishness emerge, as we strive above all not to be associated with discredited views of the past.

Here the paper's proposal is vague and speculative, even as it is earnest. I suggest that we must investigate cultural differences with an eye to taking them into account in local decision making and national policies. Culture is the symbolic soil in which policies and processes are planted. Social scientists should become more like soil scientists, who help farmers understand their soil conditions so that they themselves can make better decisions about what plants to grow and what soil treatments to undertake.

The metaphor suggests keeping our feet on the ground, and perhaps also getting **our** hands dirty, as we rethink notoriously airy topics such as culture and group differences. I hope that this approach to multicultural societies might lead not only to better decisions and policies but to a demystification of differences and similarities, fostering thereby understanding and appreciation.

Ail of these arguments suggest an agenda beyond democracy and free markets. Institutional reforms of many kinds will probably be necessary in order that South Africa is able to gain credibility for the new political and economic order, to make market and government institutions work **better for the poor, and to address the symbolic and** economic solutions to group inequalities. Such matters have received too little attention from South African policymakers and researchers, and from their foreign friends.

Figure 1

Growth and Investment, 1970-l 985

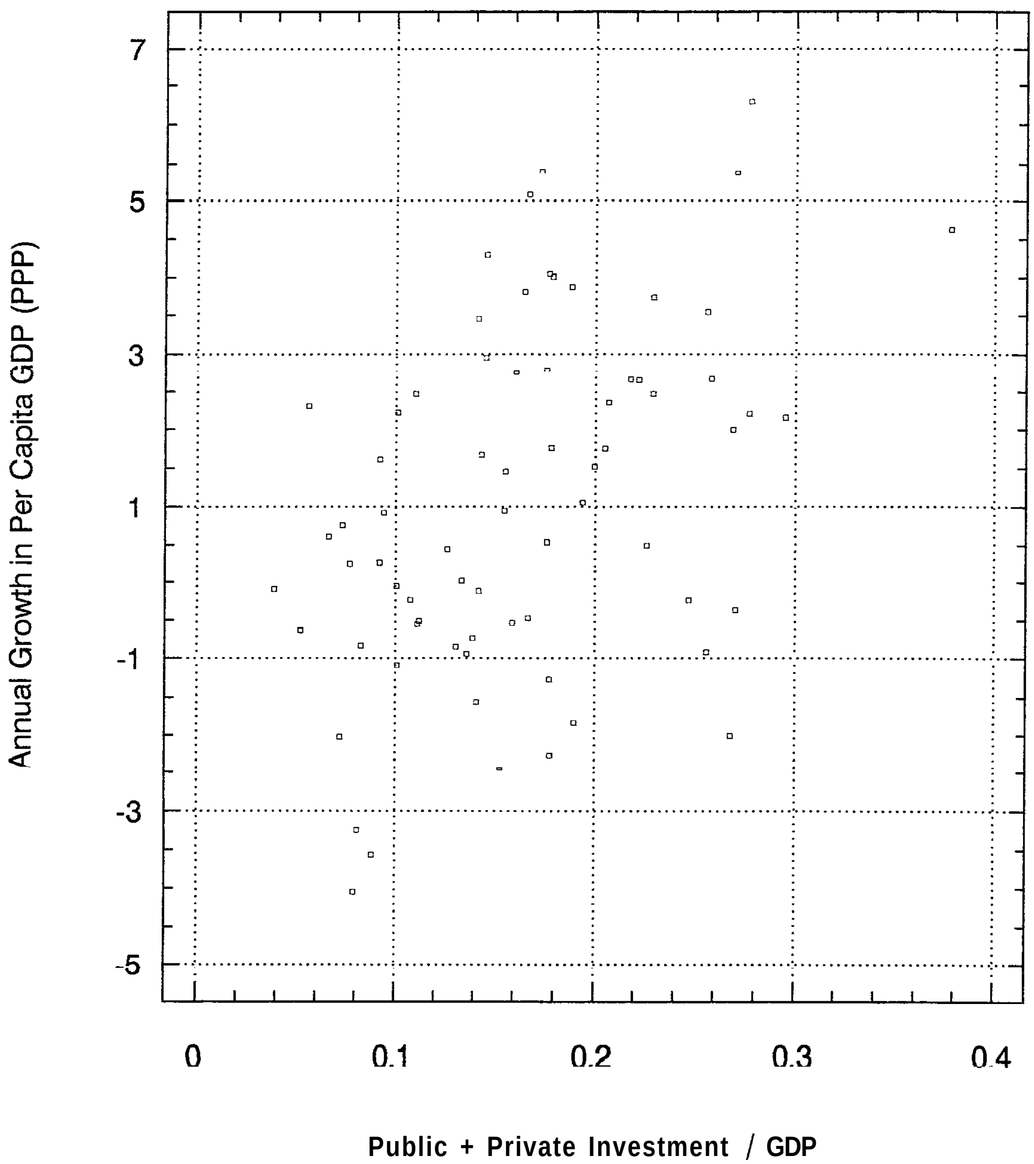
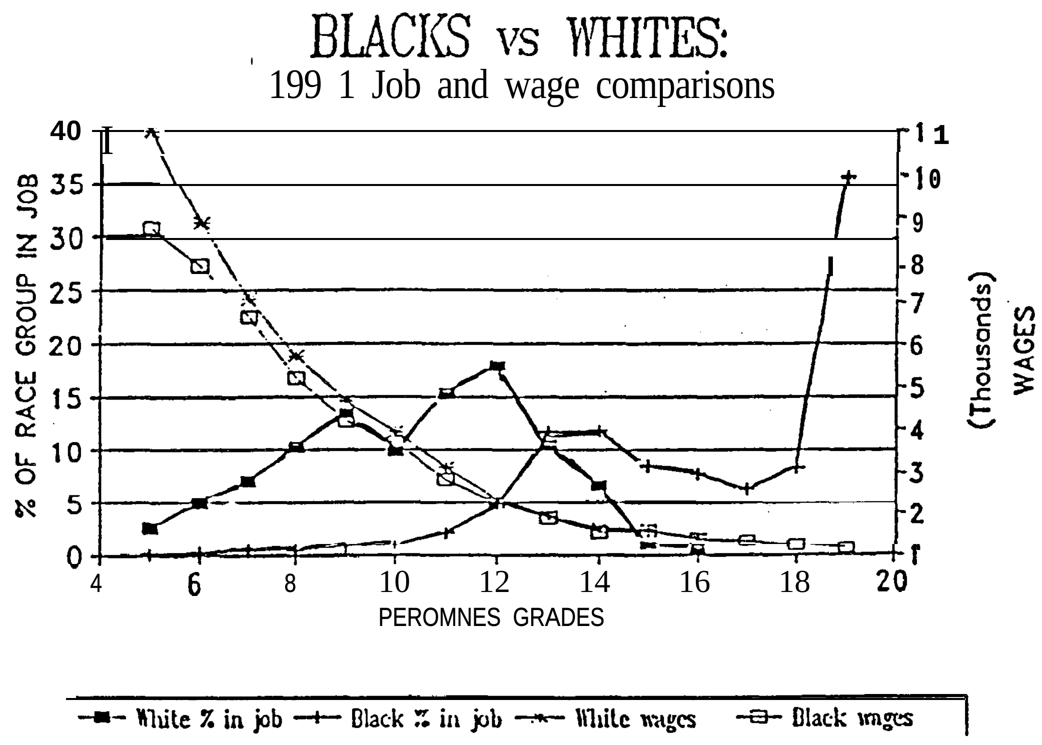


Figure 2



The figure shows job and wage inequalities among blacks and whites in a 1991 survey of 222,620 employees in South Africa (Peromnes Survey on Remuneration). In this non-random sample, about 41 percent were whites, 45 percent blacks, 10 percent coloured, and 4 percent Asian. Employees are classified into 19 grades: 1-3, top executive and the most senior specialists; 4-6, senior management and high-level specialists; 7-9, middle and lower management, superintendents and lower-level specialists; 1 O-12, supervisors and high-level skilled and clerical staff; 13-16, lower-level skilled and clerical staff; and 17-19, very low-skilled and unskilled workers. The classification of a particular job depends on eight criteria, each of which is rather subjectively estimated.

TABLE 3

Quality and Markets: A Matrix of Problems and Policy Solutions

Problem	Policy Solutions: What Sellers Can Do	Policy Solutions: What Buyers Can Do	Policy Solutions: What Government Policy Maker, and Other Third Parties Can Do
Quality varies across sellers	Form producers' groups with quality standards	(No policies required)	Regulate quality of products, processes Facilitate the formation of producer and consumer groups Regulate producer and consumer groups
Infornation is imperfect and asymmetric	Provide buyers with information about products, processes (e.g., through advertising, labeling, samples) Create brand names whose products share quality characteristics	Gather information Use consultants, information services	Improve the informational infrastructure (e.g., communications [hardware]; the development and dissemination of standards [software]; laws and policies) Measure quality
Sellers have incentives to mislead	Offer contingent contracts (e.g., warranties) Invest In reputation for quality Merge with the buyer (integrate forward)	Threaten retaliation Become a repeat customer Link the purchase of one product with the purchase of others from the same supplier Merge with the seller (integrate backward)	Put into effect and enforce contingent contracts Require high-quality sellers to stay in the market Offer arbitration (e.g., to settle a price dispute) Set prices for different qualities of goods Nationalize production or distribution